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Gold, gas and grains: smartest investment for the coming decade?

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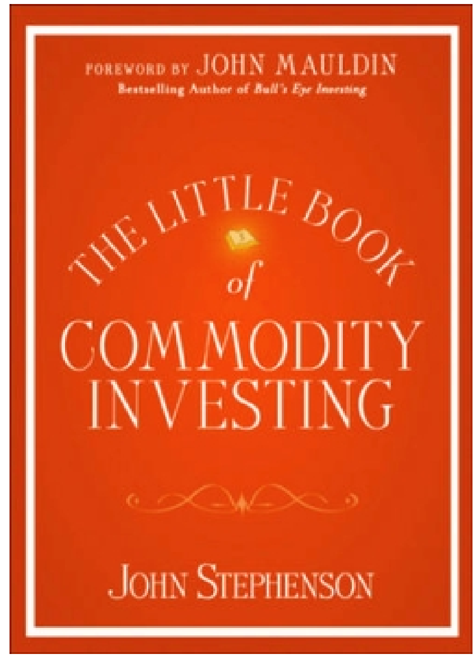

*The Little Book of Commodity Investing*may be small in size, but it is big on ideas for commodities investments. It covers the gamut of tradable commodities, such as energy and metals, and explains how an investor can participate through various instruments. It tells the story of how an education in commodities is timely, given the economic trajectory of the developing world. The author, John Stephenson, was a mechanical engineer who also holds the Chartered Financial Analyst qualification. He is currently senior vice president at First Asset Investment Management Inc.

*Little Book*starts out by explaining why commodities are the "single best asset class for the next decade" – that by 2020, two-thirds of the world's economic activity will be coming from developing economies. By developing economies, Stephenson really means China, the world's largest economy. "China is already the world's largest consumer of iron ore, copper, zinc, aluminium, nickel and coking coal. It's also the second largest consumer of crude oil and the largest producer of steel", he wrote.

With millions, if not billions of developing country inhabitants aspiring to first world living standards and consumption, coupled with their rising incomes, Stephenson is bullish on a commodities mega trend. Traditional asset classes such as stocks, bonds and real estate have, after all, been disappointing of late. For investors in the S&P 500, 2000-2009 was the worst decade in 200 years of American stock market history; with US real estate devastated by the recent sub-prime crisis and US government bond yields at record lows.

According to Stephenson, commodities, as an investment asset, can help diversify a portfolio of traditional assets, reducing the portfolio's risk while boosting its returns. Commodities can also help preserve wealth when inflation is eating away at the value of stocks and bonds. There are some qualifiers, of course, as there are stocks that can also act as an inflation hedge, depending on the inflation pass-through of the company's revenues and costs, while inflation protected bonds are available. Nevertheless, the case for commodities is built along a simple yet powerful reason. "Sluggish supply and voracious demand have set the stage for our next bull market", he wrote.

How then can an investor make a commodity investment? Owning an oil field, mine or a farm would give direct physical exposure to commodities but it is a highly sophisticated, not to mention expensive, undertaking that is not practical for most people. Futures have "roll risk" to manage while commodity index funds do not manage to track the spot prices of the commodities, since it gets its exposure from a basket of futures contracts.

Stephenson's preferred *modus operandi* is thus to participate via commodity producers. He explained that "commodity-producing companies offer leverage to rising commodity prices and the opportunity to benefit from reserve additions over time". So, chosen prudently, "commodity-producing equities can be a gift that keeps on giving," he added.

Black gold politics

There are many different types of commodities, and none of them are as visible, important, or even controversial like "black gold" – oil. Publicly-listed energy companies control just 15% of the world's known oil supply, while the rest are controlled by governments and their national oil companies. The industry faces the monumental task of finding vast, economically viable new reserves to exploit, and at current rates of productions – save for new discoveries – Big Oil (shorthand for the leading oil companies) will run out of reserves in less than 15 years.

Yet, demand is growing quite quickly, fuelled by China and India. The International Energy Agency (IEA) predicted, for instance, that out of the 93% demand from non-OECD countries, China and India alone will account for 53%. China is now the biggest car market in the world and clearly, cars need oil to run.

Enthralling stories of strong-arm tactics by Venezuela and Russia towards the oil majors, along with the political and geological risks, should serve to caution investors against the Big Oil. Still, Stephenson advised selecting companies with "long-lived oil reserves in countries with low political risk". Refiners and integrated oil and gas companies should be avoided, he said, as these companies – further down the food chain – are the "commodities' commodity", no thanks to their razor-thin margins.

Surprisingly, natural gas, found hand-in-hand in many oil fields, is a separate bet from oil. This is because prices between the two have decoupled from the historical trading ratio of 6:1. Natural gas prices vary some 50-80%, largely due to the weather, since it is primarily used for heating and cooling, and demand is stronger during winter.

Natural gas prices are also more volatile than oil prices, for unlike oil, gas tends to be priced and traded only within specific regions and not globally. However, once natural gas prices recover, Stephenson would favour investing in the service companies that specialise in horizontal drilling and reservoir fraccing – a method used by drillers to boost output by creating cracks between underground rocks.

Gold, silver and other metals

Of course, the world of commodities investing is not limited to oil and gas. In his book, Stephenson noted that "a perfect storm is brewing" to lift gold and precious metal prices. Precious metals often outperform the traditional asset classes during times when banks are stressed and the US dollar is weak. "Add inflationary pressures into the mix and you've got the conditions for an explosive rally in precious metals", he wrote.

Under the weight of massive debts, Western governments might find it tempting to debase their currencies to get out of its problems. To a large extent, this is already happening. In such an environment, gold becomes the currency of choice, since its limited supply prevents central banks from inflating away its value. Its scarcity is reflected in a surprising fact: All the gold mined since it was first discovered would fill just two Olympic-sized swimming pools. "The ratio of gold to paper currencies is currently at an *all-time low*, which suggests that the stage is being set for a powerful rally," wrote Stephenson.

How should investors ride along this gold rally? Stephenson's instrument of choice would be exchange traded funds (ETFs), investment funds traded on stock exchanges that focus on either a basket of shares or other assets. An ETF that tracks gold prices would be the SPDR Gold Shares, which accounts for two thirds of the total gold ETF market. What makes this ETF more attractive is its low management fee – less than 1% of sum invested. In contrast, physical gold, such as gold bars or coins, incur not only transaction fees but also storage and insurance costs.

Silver, the poor cousin to gold, offers another interesting prospect, wrote Stephenson. The price ratio between gold and silver, as of 2009, was around 70:1 – a significant gap compared to the 200-year-average of 32:1. If historical trends are anything to go by, silver would be undervalued. Furthermore, in addition to being a store of value, silver also has industrial uses such as electrical contacts and conductors, given that it has the highest conductivity of all metals.

Consider also the growing popularity of platinum and palladium, both of which are demanded more and more in the automotive industry for their use in reducing exhaust emissions. Recovering global industrial production makes the case for investing in these precious metals. The same goes for the heavy metals or base metals such as copper, aluminium and zinc, where their prices are the first to move when global industrial production begins to accelerate.

Steel, the father of industrial metals, gets an entire chapter in *The Little Book* – unlike the other metals which were each covered within subsections. "Steel is produced all over the world and is seen as a key industrial pillar because it provides the necessary raw materials for prestige industries such as appliance and automobile manufacturing." Stephenson observed as well, the fragmented makeup of the industry, where the top 10 players account only for 27% of world production at the end of 2007. For copper, this figure stands at 57%.

It is also not possible to talk about steel without talking about the key players involved: the ones that call the shots. China has, in recent years, emerged as the biggest producer of iron ore. Its steel output exceeds that of Brazil, Russia, Ukraine, Germany, India, South Korea and the US combined. Yet, the country also happens to be the largest consumer of steel, with an appetite so big that it relies on imports of iron ore to keep its steel mills humming.

Investors keen to take a closer look at steel should keep an eye on the Baltic Dry Index – which tracks global shipping rates, Stephenson recommended. This is because iron ore, steel and metallurgical coal all have to be transported by sea, and rising shipping rates can suggest rising iron demand. Unlike other commodities, there are no futures contracts for iron ore and coal that investors can trade in, so exposure to the bulk metal would be through investments in the producers of iron ore, coal and steel.

Stephenson also expounded on why investing in foodstuffs commodities, such as grains, cocoa, coffee, sugar, and even fertiliser ingredients such as potash, makes sense in a world of rapid population growth and urbanisation. "Grains are among the least cyclical of all commodities because eating is something we all need to do."

Conclusion

All in all, *The Little Book of Commodity Investing* is a good primer to the world of commodities, filled with stories of the author's own forays into trading rooms and mining towns. It might have been helpful, however, if Stephenson had balanced his enthusiasm for commodities with views on whether the record prices of some commodities (e.g. gold) still justify further bullishness. Also, some ink could be spared to explore instances where investments in commodities might not offer as rosy a picture as he had so optimistically painted.

Those in the know might consider *The Little Book* as Commodities 101, where further reading would be quite necessary before putting ideas into action. Nevertheless, the book is premised on the belief that a basic understanding in commodities can help good investors become better investors – not just in commodities, but across other asset classes, because, as Stephenson put it, "you will be better able to understand markets, whole economies and the world we live in".

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